Chapter 1

Trends in foreign investment and trade in Lao PDR

This chapter describes the Lao People’s Democratic Republic’s (Lao PDR) gradual integration in the world economy and the role of trade and investment in its economic development. It reviews trends in foreign direct investment in Lao PDR using various national and international data sources. It also looks at the performance of foreign investment relative to neighbouring and regional economies and its impact on the local economy.
Lao PDR has gradually integrated into the global economy

After embarking on an ambitious structural reform process in 1986 under the New Economic Mechanism, Lao PDR gradually moved from a centrally planned economy to a more open, private sector-led and market-oriented economy and progressively integrated into the world economy. In 1992, it joined a programme of sub-regional economic cooperation among Greater Mekong Sub-region countries supported by the Asian Development Bank and designed to enhance economic relations among members. In 1997, Lao PDR became a member of the Association of Southeast Asian Nations (ASEAN), one of the fastest-growing regions in Asia, which boosted its economic reforms and supported its growing integration into the regional and global economy.

Following the move of neighbouring China (2001), Cambodia (2004) and Viet Nam (2007), Lao PDR became a member of the World Trade Organization (WTO) in 2013 after 15 years of negotiations. During this period, over 90 laws and regulations were enacted to be aligned with WTO principles, including on trading rights, import licensing, customs valuation, investment, sanitary and phyto-sanitary measures, technical barriers to trade, and intellectual property rights. Lao PDR became the last ASEAN Member State to join the organisation. In September 2015, it was one of the first WTO members to ratify its Trade Facilitation Agreement, which contains provisions for expediting the movement, release and clearance of goods, and includes co-operation and capacity building components.

Tariffs are bound at 18.8% on average for all products (19.3% in agriculture and 18.7% in non-agricultural sectors) and Lao PDR has committed to liberalise ten services sectors. These commitments are meant to be implemented fully over a maximum period of seven years after the date of accession (2020). The government will also need to disseminate its accession package to various stakeholders so that, on the one hand, public agencies better understand the contractual obligations that bind the country and, on the other hand, the private sector is aware of the new opportunities that arise from joining the WTO.

Lao PDR maintains strong trade relationships with its neighbours. In 2014, Thailand accounted for over a quarter of its exports and 55% of its imports. China represented 35% of its exports and a quarter of its imports, while Viet Nam followed as the third trading partner (EIU, 2015). These three countries are also the largest sources of foreign investment (see below). Lao PDR’s major exports are mining products, which represent almost half of exports, and electricity – which are also the two major economic sectors attracting FDI (Table 1.1). Lao PDR’s imports mostly
include intermediate products and raw materials as well as capital goods. These figures confirm that economic growth and trade are driven by the exploitation of natural resources while manufacturing products are mostly imported.

Table 1.1. Lao PDR’s main exports and imports, 2014

<table>
<thead>
<tr>
<th>Exports</th>
<th>% of total</th>
<th>Imports</th>
<th>% of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mining products</td>
<td>48.3</td>
<td>Intermediate products and raw materials</td>
<td>43.4</td>
</tr>
<tr>
<td>Electricity</td>
<td>21.4</td>
<td>Capital goods</td>
<td>29.6</td>
</tr>
<tr>
<td>Garments</td>
<td>7.6</td>
<td>Durable goods</td>
<td>18.6</td>
</tr>
<tr>
<td>Agricultural and forestry products</td>
<td>8.6</td>
<td>Electricity</td>
<td>1.8</td>
</tr>
</tbody>
</table>

Source: EIU, 2016.

While FDI has been a key driver of growth in the past ten years, domestic investments have increased significantly over the same period. Investment as a share of GDP peaked in 2015 at 33% (Figure 1.1), higher than either Cambodia (22%) or Viet Nam (28%) and reflecting the natural resource boom, considering that its investment to GDP ratio was below that of its neighbours until 2003.

Private investment has increasingly been recognised by the authorities as a key engine of economic growth and development. Promoting FDI became a priority of the government in its third five-year National Socio-Economic Development Plan (NSEDP) for 1991-95 while the development of small and medium-sized enterprises (SMEs) became an area of greater focus since the adoption of the National Growth and Poverty Eradication Strategy in 2004. More recently, the Seventh NSEDP for 2011-15 aimed to achieve the Millennium Development Goals through economic growth, human resource development and improved social welfare. The Seventh NSEDP put emphasis on mobilising quality FDI with a view to generate government revenues, create sustainable jobs and generate transfers of skills and technology while safeguarding the environment. The Eighth NSEDP (2016-20) focuses on developing education and labour skills, pursuing economic diversification and supporting the development of SMEs, with the ambition to graduate from least developed country status by 2020.
Figure 1.1. Investment to GDP ratios in Lao PDR, Cambodia and Viet Nam, 2000-2015


Economic challenges

The government faces considerable challenges to achieve sustainable economic development. Growth has not been sufficiently inclusive, as poverty and inequality remain high. The economy is not sufficiently diversified and the resource movement effect, coupled with the appreciation of the real exchange rate (by 50% between 2001 and 2009), has generated slow growth of non-resource sectors, notably manufacturing and agriculture (OECD, 2016).2

Low productivity constitutes one of the major challenges in Lao PDR’s socio-economic development, which not only affects the quality of jobs but also the investment climate as a whole and the capacity to attract more and better investment. The World Bank’s Investment Climate Assessment of Lao PDR notes that an inadequately educated workforce has become the main constraint to private sector expansion (World Bank, 2014). The survey undertaken for the Global Competitiveness Index 2016-17 strongly corroborates these findings (Figure 1.2) Low productivity also affects the development of domestic SMEs and hinders the creation of business linkages with foreign affiliates. The objective of the upcoming NSEDP to focus on education and labour skills is a recognition by the government of the necessity to tackle this problem as a priority.
The country also lacks modern and affordable infrastructure, especially transport, as also reflected in Figure 1.2. As the only landlocked country in ASEAN, but strategically located between China, Thailand and Viet Nam, Lao PDR will need transport facilities to achieve sustained growth and attract investors. In the context of a natural resources boom, the government will need to find a sustainable model of development, where natural resources are preserved and exploited in an environment-friendly manner and through responsible business practices. To face these challenges, Lao PDR will not only need to attract more investment but also to make sure investors act responsibly.

Lastly, Lao PDR also faces governance issues, with private sector representatives complaining of a wide-ranging lack of transparency, constant policy uncertainty and inconsistent application of the law. Corruption is perceived as a major concern, as reflected in the Corruption Perception Index, where Lao PDR ranked 123rd out of 175 countries in 2016, a strong improvement from 145th out of 175 in 2014 but still a poor result globally and regionally, although better than either Cambodia (150th) and Myanmar (147th).
FDI trends

FDI has played an important role in Lao PDR’s recent economic growth. Although NEM reforms were initiated in 1986, FDI flows to Lao PDR only started surging in 2006, after a short peak in 1996 (Figure 1.3). Prospects for increased inflows of FDI in the coming years are encouraging, including in the non-resource sector, with the full implementation of the ASEAN Economic Community. Lao PDR is also increasingly perceived by multinational enterprises (MNEs) as an alternative to production bases in Thailand or southern China as well as an opportunity to reach the broader Mekong region (US Department of State, 2015).

Figure 1.3. FDI inflows to Lao PDR, 1986-2015

Source: UNCTAD FDI database (2016).

FDI by sector and country

Foreign investment in Lao PDR is prominent in electricity generation and mining (Figure 1.4) representing over half of the total FDI stock and contributing strongly to the rapid economic growth over the past decade. The mining sector in Lao PDR mostly comprises junior companies from Australia, China and Canada. The largest mining projects are Phu Bia Mining Ltd., which is 90% owned by Pan Aust Ltd. and 10% by the government, and Lane Xang Minerals Ltd., which is 90% owned by MMG Ltd. and 10% by the government (OECD, 2016). Both Pan Aust Ltd. and MMG Ltd. are Chinese-owned but Australian-operated companies. Hydropower projects and dams are dominated by Chinese and Thai investors, active in generation, transmission and trading of electricity. FDI in forestry and agriculture include timber and rubber and originate primarily from ASEAN Member States and East Asian economies.
FDI in Lao PDR is dominated by three of its largest neighbours, China, Thailand and Viet Nam, which are also its main trading partners. The three countries account for almost three quarters of all approved FDI projects (Figure 1.5). Chinese investors, with almost a third of total investments, are concentrated in hydropower generation, transmission and trading of electricity but also in mining, agriculture and real estate. Thai and Vietnamese investments are concentrated in hydropower, agriculture and construction projects.

Investment by OECD-based companies is rather low in Lao PDR. Korea, the largest OECD investor country, is the fifth most important foreign investor with only 4% of Lao PDR’s FDI stock. Korean companies are well anchored in the economy, however, and are present in different economic sectors. Kolao Holdings, for instance, is one of the largest Korean investors present in manufacturing, mostly active in the automobile industry (including processing and assembling activities as well as distribution). Lao PDR and the Republic of Korea have been expanding economic and political ties, including with the creation of a Korea Trade-Investment Centre office in Vientiane in 2011, a direct flight connection between Vientiane and Seoul and the rapidly growing number of Korean tourists.
Japan, which is the largest investor in ASEAN as a whole, only accounts for 2% of total FDI projects in Lao PDR. This might be explained by the fact that Japanese companies are mostly present in small manufacturing operations rather than large mining and hydropower projects. Nikon, for instance, established a camera production operation in 2013. The same year Toyota Boshoku established a plant to produce interior components and seat covers for automotive manufacturers operating in the region (ASEAN, 2014). Suzuki (automotive) and Toshiba (hydropower) are other Japanese investors. Other recent OECD investments include the Coca-Cola Company (USA) and Bosch (Germany). Although not a major investor in absolute terms, Australia has a long-lasting presence in many different sectors of the Lao economy, including mining, manufacturing and financial services.

Most of the manufacturing FDI is located in SEZs. Savan-Seno in Savannakhet, the first SEZ established in 2002, is particularly appealing to companies wishing to locate on the East-West Economic Corridor linking Viet Nam, Lao PDR, and Thailand. In addition to Korean and Japanese investors – very present in SEZs – neighbouring countries are active in zone development and investment. At least four of the ten special economic zones in the country were established with Chinese financing. In the context of ASEAN integration, Malaysian and Thai manufacturing companies have also invested in apparel plants to benefit from lower labour costs and preferential market access to the European Union (Farole and Winkler, 2014).
FDI performance

Lao PDR doubled its total stock of foreign investment between 2010 and 2015 but is still low by regional standards, with the sole exception of Myanmar – although inflows into Myanmar are growing rapidly (Figure 1.6). The country’s total FDI stock as a percentage of GDP (39%) accounts for just over half of ASEAN’s average (70%), which suggests that foreign investment still plays a limited role in the Lao economy as compared to regional peers. Neighbouring countries such as Viet Nam (54%) and Cambodia (81%) show a substantially stronger role of FDI in their economy. The same is true when FDI is normalised by population. The stock of FDI per capita of USD 713 in Lao PDR, although growing rapidly, is lower than almost all its neighbours – except Myanmar – and especially compared to the region’s average of USD 2700.

Figure 1.6. FDI in relative terms in Lao PDR and the region, 2015

Source: UNCTAD FDI database (2016).

Looking at performance over time, FDI inflows to Lao PDR in relative terms – both per capita and as a percentage of GDP – have almost always been below neighbouring Cambodia and Viet Nam since 1990 (Figure 1.7). It is only in 2014, when it attracted significantly higher amounts of FDI than previous years that Lao PDR reached the level of its regional peers and surpassed them in 2015. Its stock of FDI as a share of total FDI stock in CLMV countries has stayed roughly constant at around 2-3% since 2000, equally suggesting little progress in attracting FDI attraction vis-à-vis its neighbours.
Impact of FDI

Under the right conditions, FDI can enhance an economy’s productive capacity and growth potential, drive job creation and income growth, allow the transfer of technology and know-how, and spur domestic investment, including through the creation of local supplier linkages (OECD, 2015a). Such benefits can act as a powerful force for development and poverty eradication, but investment should not be seen as an end in itself. The growth and development impact of investment will depend as much, if not more, on the quality of the investment as it does on the quantity.

A closer look at the type of FDI in Lao PDR provides insights into the nature of its economic impact. Most FDI projects are directed to natural resource sectors (mining and hydropower) and evidence suggests that they have been among the main drivers of economic growth though capital accumulation over the past decade (Kyophilavong and Nozaki, 2015; Nolintha, 2015). The nature of these projects makes them also major contributors to exports, as mining products and electricity account for over two thirds of total exports (Table 1.1 above). Natural resource exploitation by foreign MNEs also generates government revenues, which represent a significant fiscal take for the authorities (Nolintha, 2015). With the appropriate policy framework, government revenues can help transform natural capital into physical, social and human capital (OECD, 2015b). The International Monetary Fund notes that mining revenues in Lao PDR are low, however, which undermines the opportunities for the government to
increase its spending on education and health that are below the level of comparable countries (IMF, 2015).

The exploitation of natural resources is also associated with certain risks, not the least being the “Dutch disease”, which occurs when the domestic currency appreciates as a result of the increase in resource prices, affecting in turn the production and export of other tradable goods. Researchers found that Lao PDR is no exception to this trend with a real exchange rate appreciation of 3.5% on average due to foreign capital inflows during a period of three years (Kyophilavong and Nozaki, 2015). Another study found that the real exchange rate appreciation negatively affected the price competitiveness of the garment industry, one of the major non-resource tradable sectors, although these firms benefitted nonetheless from technological upgrading (Nolintha, 2015).

Another feature of natural resource endowments is the risk they pose in terms of encouraging rent-seeking behaviour and corruption instead of entrepreneurial and value-adding activities (OECD, 2015b). In Lao PDR, large investment projects in natural resource sectors are subject to concession agreements, usually negotiated on a case-by-case basis between the government and the investors, as explained in subsequent chapters of the report. This approach allows private investors to receive strong protection provisions from these agreements, but it has also generated opportunities for rent-seeking among dealmakers and facilitators while discouraging structural reforms in the wider investment climate (World Bank, 2014). These deals typically encompass generous tax incentives, which generate significant revenue losses for the government although, as explained above, they constitute one of the main expected benefits from natural resource-seeking FDI. The examples of Chile and Botswana show that good governance and strong institutions are key ingredients to successfully realise the potential contribution of natural wealth to socio-economic development (Box 1.1).

The contribution of foreign investment to employment has been limited and can also be explained by the nature of FDI projects (Nolintha, 2015). Many MNEs operating in the natural resource sectors in Lao PDR either bring foreign labour for the construction of their projects or hire local workers but mostly for low-skilled jobs and during a limited period of time. As the authorities devote considerable efforts and sometimes resources to attract large foreign investors, domestic SMEs tend to feel, if not left out of the government’s attention, sometimes discriminated in favour of large foreign companies.
Box 1.1. Avoiding the "resource curse": The case of Botswana

Botswana is a sparsely populated, arid, landlocked country. At independence in 1966, it was one of the world’s poorest countries, with per capita income of just USD 70 a year. In the first few years following independence, about 60% of current government expenditure consisted of international development assistance. There were only 12 kilometres of paved roads, and agriculture (mostly cattle farming for beef production) accounted for 40% of GDP. About 40 years later, in 2007, Botswana had 7,000 kilometres of paved roads, and per capita income had risen to about USD 6,100 (equivalent to USD 1,000 in 1966 prices and USD 12,000 at purchasing power parity), making Botswana an upper-middle-income country, comparable to Chile or Argentina.

Botswana’s extraordinary growth was fuelled by minerals, particularly diamonds, but underpinned by good governance. The government established respect for property rights and the rule of law. It maintained a high degree of transparency, which was reinforced by continuing the Tswana tribal tradition of consultation. In addition, the first post-independence government made two key decisions: it passed a Mines and Minerals Act that gave all mineral rights to the state rather than to the tribal authorities and renegotiated a deal with the mining firm DeBeers in 1975, which allocated half of all net profits from diamond mining to the state. Also, Botswana did not adopt a policy of import substitution, nor did it expand the extent of state-owned producing entities.

The ensuing revenues for the government, primarily from diamond exports, were channelled into investments in education, health care and infrastructure, while tight fiscal control was maintained. A contributing factor has been the creation of a set of fiscal rules – a Sustainable Budget Index – to avoid deficits. In particular, government expenditure must stay in line with non-mineral fiscal revenues in order to make sure that key government functions can be kept up in case of a downturn in the commodity sector. A similar mechanism is in place in Chile.

Source: OECD (2015b) based on "Botswana’s Success: Good Governance, Good Policies, and Good Luck", in Yes Africa Can, Success Stories from a Dynamic Continent, World Bank.

Similarly, resource-seeking FDI is usually capital- and technology-intensive, limited in time and conducted in isolation, thus generating few spillovers and business linkages with domestic companies (Farole and Winkler, 2014). It is usually considered that market-seeking and efficiency-seeking FDI tend to generate more linkages, except, in the case of the latter, if they are exclusively motivated by cheap labour and focused on assembly and export activities. These tendencies are not set in stone and policies can be implemented to facilitate linkages and enhance the development impact of FDI (see Chapter 5 on investment promotion and facilitation). Lastly,
resource-seeking FDI are particularly likely to have potentially harmful consequences if not conducted with due diligence. Mining, hydropower and forestry investments in Lao PDR have important social and environmental implications, and for which responsible business conduct by MNEs is a key component for making investment work for development (see Chapter 6 on responsible business conduct and Chapter 8 on investment framework for green growth).

In parallel, SEZs have been developed to meet the development objectives of the government, which gave more importance to SEZ development in its Seventh NSDEP for 2011-15. Since Savan-Seno – the first zone in the country – was established in 2002, SEZs have attracted numerous FDI projects, mostly relatively small if compared to natural resource based investments, but in higher value-added sectors such as manufacturing and logistics. The Secretariat of the National Committee for Special Economic Zones estimates that, as of mid-2015, 213 companies invested USD 1.2 billion and that approximately 10 000 workers were employed in SEZs – although the proportion of Lao citizens among these workers is unknown.

It is difficult to assess the developmental impact of FDI in SEZs, but foreign investments in zones generally create direct jobs and, under certain conditions, can help a country diversify its economy and participate in global or regional value chains. The success of Savan-Seno is a good illustration of this contribution, as the zone has managed to attract world-class MNEs and integrate regional production networks with Thailand, notably as part of the production defragmentation of large companies based in Thailand (Kyophilavong and Nozaki, 2015; Nolintha, 2015). SEZs usually tend to stimulate few linkages with domestic firms, however, as explained above. Working conditions in Lao SEZs and their social and environmental implications are not closely scrutinised and the results are uncertain.
Notes

1. www.eastasiaforum.org/2014/08/09/after-joining-the-wto-whats-next-for-laos. The ten sectors are the following: business services; courier and telecoms; construction; distribution; private education; environmental services; insurance; banking; private healthcare; tourism; and air transport services.

2. This phenomenon is known as the “Dutch disease”, which occurs when capital inflows lead to real exchange-rate appreciation that negatively impacts the production and export of tradable goods.

3. Mining companies are often broken down into two categories: juniors and majors. The former are mining companies of a limited size and mostly involved in exploration activities. The latter are usually larger and involve more activities along the chain, including building and running mines.

4. CLMV countries include Cambodia, Lao PDR, Myanmar and Viet Nam.

5. An assessment based on interviews conducted as part of this Review.

References


